Analyzing Financial Condition: Basics

Learning Objectives

After completing this module you will be able to:

- Analyze companies' financial condition using a top-down approach.
- Compare and contrast financial leverage, working capital, and asset risks across companies, industries, and time.

Key take-aways:

- Financial leverage reflects the extent to which assets are financed by liabilities rather than equity. The consequences of financial leverage depend on the magnitude of the financial leverage and the risks and rewards associated with the assets.
- Financial leverage amplifies the owners' share of the risks and rewards associated with a company's assets. Risks and expected returns go together: The higher the risk investors perceive when they are considering an investment, the higher the expected return they will require to compensate for this risk.
- Analyzing the consequences of financial leverage can be problematic when assets or liabilities are not recognized on the balance sheet or objective experts' estimates are widely dispersed. In later modules, we will discuss ways to adjust reported numbers from disclosed information to compensate for some "off-balance sheet" assets and liabilities. Doing so will greatly improve your analyses. Even when it's not possible to adjust numbers because of the lack of available information, you may still be able to qualitatively assess the consequences in the broader business context.
- Insiders and outsiders need to understand assets' risks, expected returns, and measurement distributions to prepare and evaluate the usefulness of related measures. Similarly, your risk and return assessments are more informed to the extent you understand the measurement objectives, methods, inputs, and business context.
- Working capital and current ratios measure the extent to which current assets are expected to meet current liabilities and support near-term operating and investing plans. You should analyze these ratios in the broader context of the economic environment and the entity's financial leverage, asset risk, and capacity to raise financing.
- Common size balance sheets help you calibrate the relative importance of balance-sheet items, including their contributions to an entity's overall risks and expected returns. Each line item is expressed as a percent of total assets..

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Key terms:

- **Financial leverage**- Measures the degree to which a company's assets are funded through owners' equity versus liabilities. Also, extent to which owners can amplify their expected returns by issuing debt rather than issuing stock.
- **Asset risk**- When the possible future benefits associated with an asset could result in losses, meaning less than the asset's current value.
- **Working capital**- Measures a company's short-term financial health. Everything else equal, if a company's current liabilities exceed its current assets, it may not meet its obligations in the short term. Also called Net current assets.

Key formulas:

- Financial leverage[1] = total liabilities / total assets
- Working capital = current assets – current liabilities
- Current ratio = current assets / current liabilities

1 There is no universally accepted measure for financial leverage. Typically, it's measured using one of the following: L/A, A/OE, or L/OE, also called debt-to-equity ratio. The financial leverage numbers differ for the formulas, but the conclusions you draw when comparing financial leverage across companies (or over time for the same company) will be the same, providing you use the same formula for all computations.

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